

Office of Chief Counsel
Internal Revenue Service

memorandum

CC:MSR:NCE:STP:TL-N-1342-00
EWJohnson

date:

to: Mark Johnson, LMSB

from: District Counsel, North Central District, St. Paul

subject: [REDACTED] Claims
for Expansion of I.R.C. §382 Limitation

DISCLOSURE STATEMENT

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ISSUE

Whether [REDACTED] is entitled to expand its I.R.C. §382 limitation as claimed.

BACKGROUND

(b)(5)(AC)

[REDACTED]

(b)(5)(AC)

LAW

I.R.C. §382 functions to limit losses, generally net operating losses, that can be carried forward through a corporate ownership change. The limitation is calculated through several steps. As a threshold matter, the limitation for each year after the ownership change is calculated under I.R.C. §382(b) as the value of the corporation immediately prior to the ownership change multiplied by the long-term tax-exempt rate under I.R.C. §1274(d).

If the corporation has a net unrealized built-in gain at the time of the ownership change, which is defined as the excess of the fair market value of the corporate assets in the aggregate over their basis, the limitation is expanded under I.R.C. §382(h)(2) to the extent that the unrealized built-in gain is recognized within five years of the ownership change.

The I.R.C. §382 limitation is also expanded under I.R.C. §382(h)(6) for income reported after the ownership change that is attributable to the period before the ownership change.

I.R.C. §382(h)(6) was enacted in the Miscellaneous Revenue Act of 1988, Pub.L.No. 100-647, §1006(d)(22), 102 Stat. 3342, 3399. The legislative history gives the following examples as to income after the ownership change that is attributable to the period before the ownership change.

Such items could include accounts receivable of a cash basis taxpayer that arose before the change date and are collected after that date, the gain on completion of a long term contract performed by a taxpayer using the completed contract method of accounting that is attributable to periods before the change date, and the recognition of income attributable to periods before the change date pursuant of section 481 adjustments, for example, where the loss corporation was required to change to the accrual method of accounting pursuant to Code section 448.

H.R. Rep. No. 100-795 (1988).

On July 8, 1993, Chief Counsel issued Field Service Advice regarding application of I.R.C. §382(h)(6). The taxpayer incurred and deducted costs in developing software prior to the ownership change. After the ownership change, the taxpayer had

income from licensing of the software. The advice rendered was that the I.R.C. §382 limitation was expanded by the licensing income. The 1993 FSA stated that the licensing of the software was an "effective disposition" of the intangible software asset created prior to the ownership change. The 1993 FSA also emphasized "[i]n the instant case, there is an undeniable close relationship between the software development costs [incurred before the ownership change] and the licensing income [reported after the ownership change]."

On October 22, 1999, Chief Counsel issued a Technical Advice Memorandum regarding application of I.R.C. §382(h)(6). The taxpayer generally received payments for services before the services were performed and pursuant to Rev.Proc. 71-21, 1971-2 C.B. 549, the taxpayer reported the payments as income in the year the service was performed rather than in the year the payments were received. The taxpayer received payments before the ownership change for services performed after the ownership change. The advice rendered was that the I.R.C. §382 limitation was not expanded by the payments received before the ownership change for services performed after the ownership change.

At present, no regulations have been proposed or issued, and there is no case law, on the application of I.R.C. §382(h)(6).

I.R.C. §1374 creates a limitation similar to the I.R.C. §382 limitation. Under I.R.C. §1374, if a C-corporation changes to an S-corporation, and the corporation has net unrealized built-in gain at the time of the change, the corporation is liable for corporate tax on the built-in gains recognized within ten years of the change, and the net operating losses that may be carried through the change are limited to such recognized built-in gain. Similar to I.R.C. §382(h)(6), I.R.C. §1374(d)(5) expands the I.R.C. §1374 net operating loss limitation for income reported after the change that is attributable to the period before the change.

I.R.C. §1374(d)(5) also was enacted in the Technical and Miscellaneous Revenue Act of 1988, §1006(f)(5)(A), 102 Stat. at 3403-3406. The legislative history gives the following examples as to income after the change that is attributable to the period before the change.

Thus, the term 'disposition of any asset' includes not only sales or exchanges but other income recognition events that effectively dispose of or relinquish a taxpayer's right to claim or receive income. For example, the term 'disposition of any asset' for purposes of this provision also includes the collection of accounts receivable by a cash method

taxpayer and the completion of a long-term contract performed by a taxpayer using the completed contract method of accounting.

H.R. Rep. 100-795 (1988).

There is some case law on the application of I.R.C. §1374(d)(5). In Argo Sales Co., Inc. v. Commissioner, 105 T.C. 86 (1995) and Rondy Inc. v. Commissioner, T.C. Memo. 1995-372, aff'd without published opinion, 117 F.3d 1421 (6th Cir. 1997), the taxpayer changed from a C- to an S-corporation. In the period in which the taxpayer was a C-corporation, the taxpayer changed to accrual accounting. The taxpayer reported the income accrued as of the time of the accounting change over the course of several years pursuant to I.R.C. §481(a). Some of the accrued income attributable to the accounting change was reported after the change to the S-corporation. The court held that the I.R.C. §1374 limitation was increased for the accrued income attributable to the accounting change but reported after the change to the S-corporation. In Frank J. Leou, M.D., P.A. v. Commissioner, T.C. Memo. 1994-393, the cash-basis taxpayer changed from a C- corporation to an S-corporation. The court held that the I.R.C. §1374 limitation was expanded for accounts receivable collected after, but attributable to the period before, the change from the S- to the C-corporation.

Regulations have been issued on the application of I.R.C. §1374(d)(5). See, Reg. §1.1374-1 through 10. Reg. §1.1374-4(b)(3) example 4 states as follows. A C-corporation taxpayer in year 1 receives prepayment for services to be provided in year 2. The taxpayer changes to an S-corporation at the beginning of year 2. The taxpayer provides the services in year 2 and elects to report the prepayments as income in year 2 pursuant to Rev.Proc. 71-21. The I.R.C. §1374 limitation is not expanded for the prepayments reported as income in year 2.

DISCUSSION

1. [REDACTED]

[REDACTED] **Claim**

[REDACTED] as of the ownership change operated the following [REDACTED] routes:

[REDACTED]

[REDACTED]

[REDACTED]

[REDACTED]

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[REDACTED]

(b)(5)(AC)

[REDACTED]

Analysis

(b)(5)(AC)

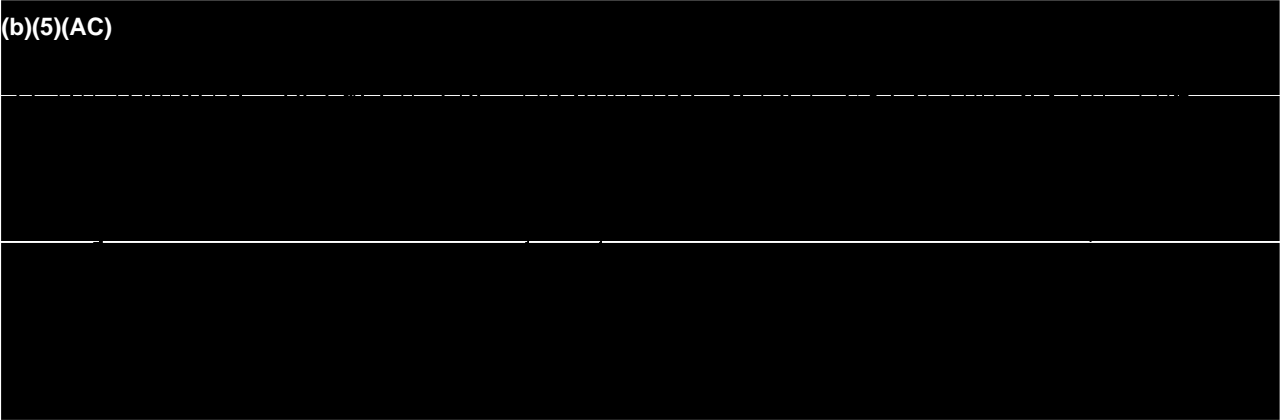
[REDACTED]

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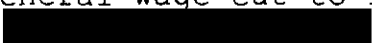

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2. Wage Cut Agreements

Claim

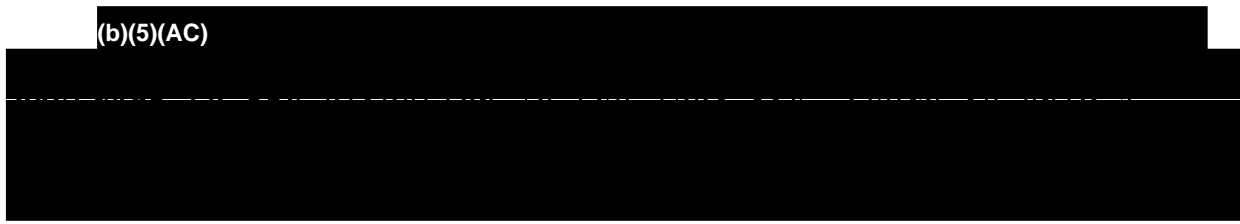
 in  negotiated a cut in wages with several of its key unions to avoid bankruptcy. The employees agreed to a general wage cut to last through . In return for the wage cut,  agreed to deferred compensation for the employees in the form of .

 argues that the income received after the ownership change attributable to the wage cut agreements should expand the I.R.C. §382 limitation.

Again,  argues that the 'wage differential' created by the wage cut agreements represented a quantifiable intangible asset as of the ownership change and that the situation is similar to that presented in the  FSA.


Analysis

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3. Prepaid Tickets

Claim

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Analysis

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4. Aircraft with Fair Market Value above Basis

Claim

at the time of the ownership change had several aircraft for which the fair market value exceeded the basis. None of these aircraft have been sold following the ownership change.

(b)(5)(AC)

Analysis

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CONCLUSION

(b)(5)(DP)

It should be emphasized, however, that determinations under I.R.C. §382(h)(6) depend heavily on factual nuances, and that this opinion should be applied in light of further or more detailed factual development.

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By: _____

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